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MEMORANDUM OF LAW

DATE: January 14, 2013

TO: Honorable Mayor and City Council

FROM: City Attorney

SUBJECT: Distribution of Settlement Funds Received from San Diego Gas & Electric Company

INTRODUCTION

The City filed litigation against San Diego Gas & Electric Company (SDG&E) in 2008 to recover damages sustained as a result of the 2007 wildfires. Damages included emergency response costs, damaged and destroyed structures, lost lease and tax revenue, damage to City reservoirs, destroyed ecological habitat, and attorney's fees and costs. Much of the damage was to assets of the Water Utility Fund and the Sewer Revenue Fund, which funded some of the litigation costs. The City received about \$16 million dollars from the Federal Emergency Management Agency (FEMA) and the California Emergency Management Agency (Cal EMA) towards some of these damages and costs. In June 2012, the City reached a settlement with SDG&E for \$27 million. The \$27 million has been deposited into the Public Liability Fund.

QUESTION PRESENTED

May the entire \$27 million in settlement funds from SDG&E remain in the Public Liability Fund?

SHORT ANSWER

No, the \$27 million settlement includes water and wastewater revenue. The City must reasonably apportion the \$27 million settlement between the General Fund, the Water Utility Fund, and the Sewer Revenue Fund taking into consideration the \$16 million received from FEMA and Cal EMA, and the breakdown of the settlement the City received from SDG&E.

ANALYSIS

I. WATER AND WASTEWATER REVENUE MAY ONLY BE USED FOR WATER AND WASTEWATER PURPOSES.

From a practical perspective, most City residents are both taxpayers and water and sewer ratepayers. But from a legal perspective, taxpayer funds and ratepayer funds must be separated, with ratepayer funds used only for the purposes for which they were received. All revenue of the City's water and wastewater utilities must be deposited into the Water Utility Fund and the Sewer Revenue Fund, respectively. San Diego Charter § 53; SDMC § 64.0403(a). Water and wastewater funds are held in trust to guarantee sufficient revenue to provide water and wastewater service through self-sustaining, financially independent utilities. City Att'y MOL No. 2006-6 at 6-7 (Mar. 16, 2006). Water and wastewater funds may only be used for purposes related to the construction, operation, and maintenance of the City's water and wastewater systems. San Diego Charter § 53; SDMC § 64.0403(b).

These restrictions are reinforced by Proposition 218, which added article XIII D to the California Constitution in 1996. Section 6 of article XIII D imposed new requirements for property-related fees and charges like water and wastewater service fees. *Bighorn-Desert View Water Agency v. Verjil*, 39 Cal. 4th 205 (2006). These requirements include a restriction that the revenue from fees and charges not exceed the cost to provide the property-related service. Cal. Const. art. XIII D, § 6(b)(1). This cost of service restriction in Proposition 218 is intended to prohibit diverting ratepayer funds to pay for unrelated projects or services. City Att'y MOL No. 2008-12 (Aug. 4, 2008). Water and wastewater funds may not be used to pay for governmental services available to the general public, such as police or fire services. Cal. Const. art. XIII D, § 6(b)(5).

Furthermore, the City's water and wastewater bond covenants require all revenue derived from the ownership or operation of the water and wastewater utilities to be used only for water and wastewater purposes. As a condition of obtaining public financing of capital improvements to the water and wastewater systems, the City agreed to hold all water and wastewater funds in trust to be used solely for water and wastewater purposes. *Amended and Restated Master Installment Purchase Agreement* (Water MIPA) § 5.02 (Jan. 1, 2009); *Master Installment Purchase Agreement* (Wastewater MIPA) § 5.02 (Sep. 1, 1993). Water and wastewater funds, called "system revenues" in the Water and Wastewater MIPAs, are defined as "all income, rents, rates, fees, charges and other moneys derived from the ownership or operation of the [Water or Wastewater] System." Water MIPA §1.01; Wastewater MIPA §1.01. Use of water or wastewater funds for any purpose unrelated to the water or wastewater system would violate the terms of the MIPAs.

This Office has issued many opinions over the years explaining that water and wastewater funds may only be used for water and wastewater purposes. City Att'y Report 2010-6 (Feb. 24, 2010) (rejecting the use of water funds to pay for operating and maintaining a public park); City Att'y MOL No. 2001-12 (July 12, 2001) (rejecting the use of wastewater funds for a permanent sound wall to block noise from rush-hour traffic); City Att'y MOL No. 93-22 (Feb. 22, 1993) (rejecting the use of wastewater funds for improvements to Sunset Cliffs Natural

Park); City Att'y MOL No. 95-07 (Jan. 24, 1995) (cautioning against the use of wastewater funds to pay for street repaving beyond that portion impacted by sewer pipe replacement); City Att'y MS No. 2002-01 (Jan. 28, 2002) (concurring with the use of wastewater funds as a reward for the capture and conviction of those vandalizing the wastewater system); City Att'y Report 91-53 (Nov. 13, 1991) (agreeing with the use of water funds to maintain fences, roads, and restrooms open to the public when such facilities are necessary for water utility purposes).

II. THE \$27 MILLION SETTLEMENT INCLUDES WATER AND WASTEWATER REVENUE THAT MUST BE DEPOSITED IN THE WATER UTILITY FUND AND THE SEWER REVENUE FUND.

On January 25, 2011, the City Council authorized the expenditure of \$117,858 from the Water Utility Fund and \$7,858 from the Sewer Fund, towards an estimate of \$550,000 in litigation costs. San Diego Resolution R-306556 (Jan. 28, 2011). Prior to authorizing the expenditure at a City Council meeting, the question was raised whether it was appropriate to spend water and wastewater funds on litigation. We explained it was appropriate because the City was pursuing damages from SDG&E on behalf of the water and wastewater utilities:

COUNCILMEMBER LIGHTNER: I was curious as to why funds were being taken from water and wastewater funds for litigation?

DEPUTY CITY ATTORNEY BAILEY: Yes, my name is Bruce Bailey and I'm the primary one responsible. For the wildfire, wild land fire case, what has happened is we needed some more funds. I spoke with people at Risk Management, and what we determined was generally a percentage. If we have X number of dollars of damages, then we looked at what the damages were for the water department, and we looked at the damages for the wastewater department, and basically it came out to be 75% General Fund, with about 25% to both the water departments. More specifically, it came out to be 20% generally for the water department and 5% for the wastewater.

COUNCILMEMBER LIGHTNER: I notice Mr. Zeleny is here, so the next question will come as probably no surprise. Does this serve actually a water related purpose, as we were unable to fund watershed management for the JPA with water fund monies. I'm curious how we can fund litigation?

DEPUTY CITY ATTORNEY ZELENY: Tom Zeleny, City Attorney's Office. I'm not very familiar with the particular aspects of this case, but in general my understanding is that water property and sewer facilities were damaged by the fire. So it is a proper expenditure of water and sewer funds to seek recovery for damages to their own facilities. And it's also my understanding that the amount they are paying is proportionate to the damages that they incurred as a result of the fire, so yes, it is a proper expenditure of water and sewer funds.

COUNCILMEMBER LIGHTER: Move the item.

In addition, this Office has previously advised that spending water and wastewater funds on litigation is appropriate provided the water and wastewater utilities receive a proportionate benefit. City Att’y MOL No. 90-75 (June 27, 1990). In 1990, the City was actively opposing a proposed merger of SDG&E and Southern California Edison because of concerns the merger would result in higher electricity costs. The City had appropriated about \$5.5 million towards that effort, solely from the General Fund. This Office explained that because the water and wastewater utilities would be adversely impacted if electricity rates went up, the water and wastewater funds could contribute towards opposing the merger. This Office concluded that water and wastewater funds could reimburse the General Fund for half the litigation costs incurred to date because the water and wastewater utilities were responsible for about half of the City’s total electricity costs.

The \$27 million settlement includes water and wastewater revenue. The settlement with SDG&E was reached, in part, through the expenditure of water and wastewater funds on litigation costs, and damages pursued by the City on behalf of the water and wastewater utilities. If the City did not own or operate the water and wastewater utilities, the City could not have pursued damages from SDG&E on the utilities’ behalf. Recovery of such damages is therefore sufficiently related to ownership or operation of the utilities to make the recovery water and wastewater revenue within the meaning of the laws governing the water and wastewater funds discussed above. The portion of the settlement that is water and wastewater revenue must be used for the benefit of the water and wastewater utilities.

Keeping the \$27 million in the Public Liability Fund would unlawfully deprive the water and wastewater utilities of any benefit of the settlement with SDG&E. The stated purpose of depositing the settlement funds into the Public Liability Fund is to provide long-term budgetary relief to the General Fund. Report to City Council No. 12-115 (Sep. 17, 2012). The \$27 million is proposed to be used over the next six years to save the General Fund \$4.5 million annually (through fiscal year 2019), which will then be redirected to fund other General Fund services. *Id.* The water and wastewater utilities do not benefit from the Public Liability Fund because the utilities have their own dedicated reserves. Council Policy 100-20. As water and wastewater revenue, part of the settlement must be deposited into the Water Utility Fund and the Sewer Revenue Fund pursuant to City Charter section 53, Municipal Code section 64.0403(a), Proposition 218, and the City’s water and wastewater bond covenants.

III. THE \$27 MILLION SHOULD BE REASONABLY APPORTIONED BETWEEN THE GENERAL FUND AND THE WATER UTILITY AND SEWER REVENUE FUNDS BASED ON THE DAMAGES RECOVERED.

Determining how much of the \$27 million should go to the water and wastewater funds could have reasonably been based on the percentage of the damages incurred by the water and wastewater utilities. At the City Council meeting when additional funds were approved for litigation costs, it was stated that about 20% of the total damages were incurred by the water utility and 5% by the sewer utility. However, that formula does not take into account the \$16 million reimbursement from FEMA and Cal EMA or the breakdown of the \$27 million received from SDG&E.

Negotiations with SDG&E resulted in a \$27 million settlement, broken down as follows: \$8 million for response and other costs, \$12 million for ecological/habitat damages, \$3 million for miscellaneous costs, and \$4 million for potential electricity rate increases. The settlement is unrestricted in the sense that the City is not contractually required to spend the funds repairing that damage or paying those costs according to the breakdown. But the breakdown provides a framework to ensure that each fund receives a share of the settlement in accordance with the damages each fund suffered, reimbursement already received from FEMA and Cal EMA, and the legal restrictions on water and wastewater revenue.

The \$8 million for response and other costs represents the difference between the \$24 million in “hard costs” (damages for which the City has receipts) the City incurred as a result of the 2007 wildfires, and the \$16 million the City received from FEMA and Cal EMA.¹ The \$24 million in hard costs were incurred by the following funds:

General Fund:	\$ 18,952,725.32
Water Utility Fund:	\$ 4,210,781.18
ESD Disposal Fund:	\$ 473,436.44
Sewer Revenue Fund:	\$ 303,665.87
<u>ESD Container Fund:²</u>	<u>\$ 19,333.92</u>
Total:	\$ 23,959,942.73

Between the \$16 million in hard costs reimbursed by FEMA and Cal EMA and the \$8 million in hard costs paid to the City by SDG&E, each of the funds listed above should be fully reimbursed for the hard costs they incurred from the 2007 wildfires. To the extent that the water and wastewater funds have not been fully reimbursed for their hard costs, the difference must be transferred to them from the \$27 million currently in the Public Liability Fund.

The water utility manages a substantial amount of undeveloped real property that was damaged or destroyed by the 2007 wildfires. The City should determine a reasonable method to apportion the \$12 million recovered for ecological/habitat damages between the Water Utility Fund, the Sewer Revenue Fund (if any wastewater property was impacted), and the General Fund. One possible method is according to the amount of acreage owned by each fund that was impacted by the wildfires. Another possible method is according to the ecological value of the affected acreage, if such information exists. We can assist City staff in determining a reasonable method to apportion the \$12 million recovered for ecological/habitat damages.

The \$3 million in miscellaneous costs is primarily for litigation costs, such as hiring experts, discovery costs (*e.g.*, depositions), and time spent on litigation by City employees. To the extent the water and wastewater funds contributed towards litigation costs, as authorized by San Diego Resolution No. R-306556, they should be reimbursed. We can assist City staff in determining a reasonable method to apportion the balance of the \$3 million if the water or wastewater funds incurred any other costs related to litigation.

¹ The City would have to reimburse FEMA or Cal EMA to the extent the settlement funds from SDG&E duplicated benefits previously received from FEMA or Cal EMA. 42 U.S.C. § 5155(c); *State of Hawaii ex rel. Atty. Gen. v. Fed. Emergency Mgmt. Agency*, 294 F.3d 1152, 1161 (9th Cir. 2002).

² This amount includes blue recycling containers which were funded through an enterprise fund, and black trash containers which were funded through the General Fund.

SDG&E is actively pursuing rate increases to recover the cost of litigating and settling all the claims against it from the 2007 wildfires. The settlement with SDG&E includes \$4 million to offset such rate increases. We recommend that the \$4 million be divided between the General Fund and the water and wastewater funds in proportion to the amount each fund pays towards the City's total electricity costs to SDG&E. This would be consistent with this Office's prior advice on how to apportion litigation costs incurred opposing the proposed merger of SDG&E and Southern California Edison in 1990. City Att'y MOL No. 90-75 (June 27, 1990). As with litigation costs, damages recovered through litigation must be shared by the General Fund and the water and wastewater funds in proportion to the potential higher electricity rates that may be incurred by each fund.

CONCLUSION

The Water Utility Fund and the Sewer Revenue Fund must each receive a share of the \$27 million settlement from SDG&E. The \$27 million includes water and sewer revenue which must be kept separate from the General Fund and can only be used for water and wastewater purposes. The proposal to keep the entire \$27 million in the Public Liability Fund does not benefit the water or wastewater utilities, and therefore would violate the City Charter, the Municipal Code, Proposition 218, and the City's water and wastewater bond covenants. The City must reasonably apportion the \$27 million settlement between the General Fund and the water and wastewater funds, taking into consideration the \$16 million received from FEMA and Cal EMA, and the breakdown of the settlement the City received from SDG&E.

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By */s/ Thomas C. Zeleny*
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cc: Andrea Tevlin, IBA
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